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# Judicial Choice and Disparities Between Measures of Economic Values

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# JUDICIAL CHOICE AND DISPARITIES BETWEEN MEASURES OF ECONOMIC VALUES<sup>©</sup>

BY DAVID COHEN\* AND JACK L. KNETSCH\*\*

An important idea, which characterizes law in society, is a reluctance to move from the *status quo*. In general, one can argue that legal institutions and legal doctrine are not engaged in the redistribution of wealth from one party to another. This paper explores a possible explanation for that principle. The authors' research suggests that, across a wide range of entitlements and in a variety of contexts, individuals value losses more than foregone gains. The paper argues, as a matter of efficiency, that law and social policy might have developed in a manner consistent with this valuation disparity. Furthermore, this valuation disparity can be transformed into conceptions of fairness, and, as a matter of fairness, legal decisions might have developed in a manner consistent with this fairness norm. In the first part of the paper, the economic and psychological research on the valuation disparity is described in detail. The paper then examines a series of legal doctrines, all of which can be explained by the valuation disparity phenomenon revealed in the experimental data. Cohen and Knetsch conclude that the behaviour of legal institutions and actors can be explained by the valuation disparity.

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## I. INTRODUCTION

The idea that the legal system should not move wealth from one person to another pervades common law doctrine and reasoning. As Oliver Wendell Holmes stated, "The general principle of our law is that loss from accident must lie where it falls."<sup>1</sup> Common explanations of that position focus on the political power and class bias of those who make legal decisions and create legal rules.

We propose an alternative interpretation of the historical truism that "losses should lie where they fall." People value actual losses far more than foregone gains, and thus, it is a matter of efficiency,<sup>2</sup> as well as of fairness, to adopt presumptive legal rules which do not direct non-consensual transfers of wealth. We explore the extent to which such disparities in valuations between gains and losses have been incorporated in legal doctrines and principles.

The following two puzzles illustrate the issue. They represent examples of apparent *irrationality* in law, which we believe are perfectly understandable in terms of common behaviour and are probably desirable.

Puzzle I: A seller sells an automobile to a buyer (B1), permitting B1 to take possession of the car before payment in full.<sup>3</sup> The seller

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<sup>1</sup> *The Common Law* (Boston: Little, Brown, 1881) at 94. As we point out later, it is not as simple as it might first appear to know *where* losses lie, in order to decide where they should fall. As well, it is clear to us that the idea to which Holmes is alluding has application far beyond *accidents*, and may inform our understanding of property rights, contract remedies, and regulatory policy.

<sup>2</sup> The definition of efficiency that we employ in this paper is quite simple. A legal decision or rule is efficient if, after its application, at least one person is better off and no one is worse off than before. We might adopt a Kaldor-Hicks definition of efficiency, which permits hypothetical compensatory wealth transfers between the affected parties; whether we choose a Pareto or such a potential Pareto superiority criterion does not matter to our thesis.

<sup>3</sup> This puzzle is equally apparent in the treatment of sales by *sellers* who remain in possession of goods. Here, sales legislation, which deals with sales by *sellers in possession*, generally appropriates the interest of the first buyer only where the second buyer has received *delivery* of the

reserves *ownership* of the car until full payment. Before full payment, B1 enters into an agreement with a sub-buyer (B2) who pays B1 a down payment of \$500 for the car, with delivery arranged for the following day. Before delivery to the sub-buyer, the original seller discovers the sub-sale. In a dispute between the original seller claiming ownership of the car and B2, who also claims ownership, the *original seller* will win.<sup>4</sup>

A seller sells an automobile to a buyer (B1), permitting B1 to take possession of the car before payment in full. The seller reserves *ownership* of the car until full payment. Before full payment, B1 enters into an agreement with a sub-buyer (B2) who pays B1 a down payment of \$500 for the car, with immediate delivery arranged from B1 to B2. After delivery to the sub-buyer, the original seller discovers the sub-sale. In a dispute between the original seller claiming ownership of the car and B2, who in this case has taken delivery of the car and who also claims ownership, the *sub-buyer* wins!<sup>5</sup>

Puzzle II: A seller contracts with a buyer to purchase a piece of jewellery. The buyer pays \$100 as a deposit and agrees to pay \$200 per month for twelve months to pay off the purchase price of \$2,500. The buyer also agrees that, on default, the seller will be able to retain any money that has been paid as of the date of default. The buyer defaults after six months. The seller repossesses the jewellery and retains the \$1,300, which has been paid. If the buyer seeks to set aside the *forfeiture clause* and recover the amount paid, then the buyer will only be able to

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property.

<sup>4</sup> The original seller wins because at common law the first buyer could not transfer any better *title* than she or he had. Thus, the first sub-buyer could not receive any better ownership claim than *the person selling to this sub-buyer*, and would lose to the original owner. See *Cole v. North Western Bank* (1875), L.R. 10 C.P. 354 at 362, [1874-80] All E.R. Rep. 486, 44 L.J.C.P. 233. See generally, M.D. Chalmers, *The Sale of Goods Act, 1889* (London: William Clowes & Sons, 1905) at 57-66.

<sup>5</sup> The outcome is produced through the operation of section 25(2) of the original English *Sale of Goods Act* (U.K.), 1893, c. 71, which re-enacted with some slight modifications section 9 of the *Factors Act* (U.K.), 1889, c. 45 [hereinafter *Factors Act*]. However, that section only operates where the sub-buyer obtains *delivery of the goods or transfer of documents of title*, and thus does not protect mere contract or ownership expectations.

We should also point out that this example suggests that Holmes's insight is equally accurate of legislative action, at least where the legislative institution is purporting to create a framework for contract and ownership disputes analogous to the framework established at common law.

Finally, some insight into the reasons we protect the sub-buyer who has possession of the goods may be gained from early decisions, which refused to extend the equivalent section of the *Factors Act*, to lessees, even where the lessee had entered into a lease-option arrangement. See *Helby v. Matthews*, [1895] A.C. 471, 64 L.J.Q.B. 465, 60 J.P. 20 (H.L.).

do so if it would be “unconscionable for the seller to retain the money.”<sup>6</sup> In the vast majority of cases, the courts will leave the money with the seller.

A seller contracts with a buyer for the purchase of a piece of jewellery. The buyer pays nothing down and agrees to pay \$200 per month for twelve months to pay off the purchase price of \$2,400. The buyer agrees to pay \$1,300 on default to the seller as liquidated damages. The buyer defaults, and the seller repossesses the jewellery and sues to recover the \$1,300 as liquidated damages. The liquidated damages clause will, however, be held unenforceable where the buyer persuades the court that the clause was *intended as a penalty*. In a large percentage of the cases, the courts will refuse to enforce the clause and leave the money with the buyer.<sup>7</sup>

The *puzzle* in these examples is that the outcome differs depending on the *location* of the object of the dispute. In Puzzle I, the issue of which claimant’s ownership interest is expropriated depends on whether the sub-buyer has or has not taken delivery of the car. In Puzzle II, the issue of the enforceability of the private damage assessment term depends on whether the money has or has not been transferred to the seller.

Many writers have seen the similarity between the penalty and forfeiture cases and have argued forcefully for solutions, which would *reconcile*<sup>8</sup> the two doctrines, or which would eliminate the “illogical distinction drawn by the existing law between penalty clauses and the

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<sup>6</sup> See *Stockloser v. Johnson*, [1954] 1 Q.B. 476 at 492, [1954] 2 W.L.R. 439, [1954] 1 All E.R. 630. While there is no empirical data on this point, our impression, and the impression of most commentators, is that judicial discretion to take wealth away from the seller, and thus return monies to the buyer, is only very rarely exercised, compared to judicial willingness to review *penalty clauses*. See S.M. Waddams, *The Law of Contracts*, 2d ed. (Toronto: Canada Law Book, 1984) at 341-45.

<sup>7</sup> The distinction between the treatment of liquidated damages or penalties and forfeiture clauses becomes even more problematic where the defendant has promised to pay a deposit, which is subject to forfeiture on breach, and then fails to pay it. The cases are split on this third situation. Some hold that the buyer must pay, which treats the arrangement as a forfeiture. Others hold that the arrangement represents a penalty clause in which case, as above, the buyer does not have to pay. See *Hinton v. Sparkes* (1868), L.R. 3 C.P. 161, 37 L.J.C.P. 81, 17 L.T. 600 (buyer liable for promised amount, even though penal); *Dewar v. Mintoff*, [1912] 2 K.B. 373, 81 L.J.K.B. 885, 106 L.T. 763 (amount not recoverable by seller as a penalty). See S.M. Waddams, *The Law of Damages* (Toronto: Canada Law Book, 1991) at para. 8.310.

<sup>8</sup> See Waddams, *ibid.*

doctrine of forfeiture.”<sup>9</sup> It does not matter, of course, whether the proponents of reform would prefer the penalty/liquidated damages solution over the forfeiture clause solution<sup>10</sup> or the converse. The point is that *rationality*, to some reformers, means that the situations should be treated the same way.

While the legal treatment of these cases appears anomalous, the results reflect real and important differences in valuations of losses relative to gains and in their judgments of fairness predicated on this disparity. The differences in valuations of gains and losses appear to go a long way towards explaining the *rationality* of the apparently illogical puzzles presented above, and of many others as well.<sup>11</sup> These puzzles can be explained as manifestations of the idea that *possession*<sup>12</sup> losses are much more important than foregone gains, and the law takes such real differences into account. In each case the legal rule treats economic gains and losses differently, even though nominally commensurate. These doctrines reflect powerful human sentiments:

bare expectations were less important than expectations allied to present rights, especially rights of property. Hume and Adam Smith, for example, both said that

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<sup>9</sup> Ontario Law Reform Commission, *Report on Sale of Goods* (Toronto: Minister of the Attorney General, 1979) at 425. Law Commission, *Penalty Clauses and Forfeiture of Monies Paid* (Working Paper No. 61) (London: Her Majesty's Stationery Office, 1975) at 51-54.

<sup>10</sup> The Law Commission of England would prefer that both be treated like penalty clauses, while Waddams would prefer that both be treated like forfeiture clauses. See Law Commission, *ibid.*; and Waddams, *supra* note 7.

<sup>11</sup> Common law judges seemingly apply Aristotelian concepts of corrective justice by restoring parties to the position they were in prior to the wrongful act. Law as it has developed in most common law jurisdictions implicates ideas of corrective, rather than distributive justice. Corrective justice is a system for preserving what we have and for minimizing disruptions of feelings of loss, not for bringing about new distributions of wealth.

Maintaining entitlements is implicit in law in three ways. First, compensation will usually be considered in terms of remedying actual losses to plaintiffs rather than in compensating foregone gains. Second, and more important, law will represent itself as a passive, political institution, demanding justification for transfers of wealth from defendants to plaintiffs. Finally, judicial discretion implicit in fact-finding, interpretation rule selection, and rule application may incorporate concepts of fairness, which reflect the idea that losses are much more important than foregone gains.

<sup>12</sup> While we use the word *possession* to denote the critical element in these cases as well as in the empirical studies, which we describe, we are not suggesting that a physical connection or even legal entitlement is a prerequisite to the occurrence of the phenomenon. The reference position from which changes are perceived as gains or losses may well depend on factors other than physical possession.

expectations arising out of rights of property deserved greater protection than expectations to something which had never been *possessed*. To deprive somebody of something which he merely expects to receive is a less serious wrong, deserving of less protection, than to deprive somebody of the expectation of continuing to hold something which he already *possesses*.<sup>13</sup>

## II. THE VALUATION DISPARITY

In each of the cases of judicial choices that we explore in this paper, greater weight is given to actual out-of-pocket losses than to the opportunity cost of foregone gains. Such asymmetries in the valuations of gains and losses are not at all consistent with the assurances of most economists that valuations of gains and losses are equivalent, or with generally accepted principles of analysis based on such assumptions of people's preferences.

There is no dispute that the economic value of both gains and losses is measured by what people are willing to sacrifice. That is, gains are valued by a payment measure, and losses are valued by a compensation measure. For example, Posner suggests, "[T]he economic value of something is how much someone is willing to pay for it or, if he [or she] has it already, how much money he [or she] demands to part with it."<sup>14</sup> Similarly, Michelman suggests, "[B]enefits are measured by the total number of dollars which prospective gainers would be willing to pay to secure adoption, and losses are measured by the total number of dollars which prospective losers would insist on as the price of agreeing to adoption."<sup>15</sup>

Although income effects or limits on ability to pay may cause the two measures to differ, these are normally not a factor of any practical importance and can safely be ignored in most applications. The common view is that, "for many goods, services, and amenities that command a modest fraction of the consumer's budget, the differences between [the] ... measures are trivial."<sup>16</sup> Consequently, the usual advice

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<sup>13</sup> P.S. Atiyah, *The Rise and Fall of Freedom of Contract* (Oxford: Clarendon Press, 1979) at 428 [emphasis added].

<sup>14</sup> R. Posner, *An Economic Analysis of Law*, 3d ed. (Boston: Little, Brown, 1986) at 11.

<sup>15</sup> F.I. Michelman, "Property, Utility, and Fairness: Comments on the Ethical Foundation of 'Just Compensation' Law" (1967) 80 Harv. L. Rev. 1165 at 1214.

<sup>16</sup> A. Randall, *Resource Economics* (New York: Wiley, 1987) at 244.

is that “as a practical matter it usually does not make much difference which of these two approaches ... is adopted.”<sup>17</sup>

Common preferences and reactions to actual choices are, however, not consistent with the assertion of equivalence between the measures of loss and gain. Nor, it seems, are judicial reactions and choices.

The traditional assumption of equivalence between the willingness-to-pay and the compensation-demanded measures of value is largely an empirical assertion that is common to both economic and legal analysis. It is based on the behavioural assumption that people assess gains and losses by comparing how well off they would be with more or with less of something—for example, by comparing how they would feel with their present wealth with how they would feel with their present holdings plus \$100; or by comparing their level of welfare with an injury and their economic well-being without one.

New empirical evidence indicates that people evaluate gains and losses in terms of changes from some reference position, instead of comparing alternative end states. This evidence also indicates that they value losses from this neutral point much more than they value gains beyond it: “[T]he aggravation that one experiences in losing a sum of money appears to be greater than the pleasure associated with gaining the same amount.”<sup>18</sup>

Virtually all controlled evaluation tests, as well as the commonplace reactions of people to real choices, point to large and persistent differences between the valuation of losses and foregone gains and do not confirm the traditional assumption that these two measures of value are equal. Large differences were first noted in survey studies of people’s valuations of various losses of environmental assets or the degradation of environmental quality. For example, a sample of duck hunters said they would be willing to pay an average of \$247 to save a marsh area used by ducks, but would demand an average of \$1044 to accept the identical loss.<sup>19</sup> Similarly, a survey of anglers yielded a

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<sup>17</sup> S.E. Rhoads, *The Economist’s View of the World* (Cambridge: Cambridge University Press, 1985) at 125.

<sup>18</sup> D. Kahneman & A. Tversky, “Prospect Theory: An Analysis of Decision Under Risk” (1979) 47 *Econometrica* 263 at 279.

<sup>19</sup> J. Hammack & G.M. Brown, *Waterfowl and Wetlands: Toward Bioeconomic Analysis* (Washington: Resources for the Future, 1974).



payment value of \$35 and a compensation value of \$100 for the loss of a fishing area.<sup>20</sup> The disparity between the two measures of value was also reported to vary from \$43 to \$120 for the loss of a fishing pier;<sup>21</sup> from \$22 to \$93 for the loss of a local postal service;<sup>22</sup> from \$21 to \$101 for the loss of a goose-hunting permit;<sup>23</sup> from \$54 to \$143 for the loss of an opportunity to hunt elk;<sup>24</sup> and from \$40 to \$833 for the loss of the chance to hunt deer.<sup>25</sup> We are not aware of any surveys reporting equivalence between the two measures.

Later studies based on real exchange experiments have provided more stringent tests than the earlier ones, which were based on hypothetical survey questions. The results have been essentially the same. Even when exchanges of real goods and actual cash payments motivated the evaluations, the compensation demanded to give up an entitlement far exceeded the comparable payment measures of value. For example, people required about four times more money to give up a lottery ticket than they would be willing to pay to acquire one.<sup>26</sup> To hunt deer in the northern United States, the values were reported to be \$25 for the acquisition of a permit and \$172 for the actual loss of a permit.<sup>27</sup>

A more recent series of real exchange experiments has affirmed the persistence of the evaluation disparities over repeated valuations, and has eliminated the possibility that the differences might be attributable to transaction costs or strategic behaviour on the part of

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<sup>20</sup> W.F. Sinclair, *The Economic and Social Impact of Kemano II Hydroelectric Project on British Columbia's Fisheries Resources* (Vancouver: Fisheries and Marine Service, Department of the Environment, 1976).

<sup>21</sup> N.D. Banford, J.L. Knetsch & G.A. Mauser, "Feasibility Judgements and Alternative Measures of Benefits and Costs" (1980) 11 *J. Bus. Admin.* 25.

<sup>22</sup> *Ibid.*

<sup>23</sup> R.C. Bishop & T.A. Heberlein, "Measuring Values of Extra-Market Goods: Are Indirect Measures Biased?" (1979) 61 *Am. J. Agric. Econ.* 926.

<sup>24</sup> D. Brookshire, A. Randall & J. R. Stoll, "Valuing Increments and Decrements in Natural Resource Service Flows" (1980) 62 *Am. J. Agric. Econ.* 478.

<sup>25</sup> R.C. Bishop & T.A. Heberlein, "Does Contingent Valuation Work?" in R.G. Cummings, D.S. Brookshire & W.D. Schulze, eds., *Valuing Environmental Goods* (Totowa, N.J.: Roman & Allanheld, 1986) 123.

<sup>26</sup> J.L. Knetsch & J.A. Sinden, "Willingness to Pay and Compensation Demanded: Experimental Evidence of an Unexpected Disparity in Measures of Value" (1984) 99 *Q. J. Econ.* 507.

<sup>27</sup> Bishop & Heberlein, *supra* note 25.

participants.<sup>28</sup> The results indicate that, consistent with other evidence and contrary to conventional assertions, people value losses much more than gains. The differences are pervasive and large. They persist over repeated valuations and they are not the result of inhibitions posed by transaction costs.

An indication of the general findings is illustrated by the results of a simple exercise involving people's actual choices between a coffee mug and a large, four-hundred-gram chocolate bar.<sup>29</sup> Each member of one group of seventy-six participants was given a mug and told to keep it. Each was then given a chance to give up the mug to obtain a chocolate bar. A second group of eighty-seven participants was given the opposite choice: to give up chocolate bars to obtain coffee mugs.

Traditional economics predicts that, in the absence of any significant transaction costs, about the same proportion of participants in each of the groups will prefer mugs to chocolate bars and will choose accordingly. The actual results were in sharp contrast to this prediction: 89 per cent indicated a preference for the mug when initially given a mug, and only 10 per cent revealed a similar preference for mugs when they had to give up a chocolate bar to obtain one. The relative value of mugs and chocolate bars varied greatly and depended on whether the evaluation was made in terms of a gain or a loss. The mug was valued more when it had to be given up to obtain a chocolate bar, and was valued less when the chocolate bar had to be given up to obtain a mug. The influence of income constraints and wealth or income effects was entirely eliminated in the exercise, leaving the choices dependent on individual preferences. These choices showed that gains and losses were valued very differently.

A further test for the equivalence or non-equivalence of valuations of gains and losses was modeled on the Coase Theorem, a mainstay of the economic analysis of law and the basis for many legal policy prescriptions. A major conclusion of the Coase proposition is that, in the absence of transaction costs and wealth effects, people are presumed to make mutually advantageous exchanges to ensure that

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<sup>28</sup> D. Kahneman, J.L. Knetsch & R.H. Thaler, "Experimental Test of the Endowment Effect and the Coase Theorem" (1990) 98 J. Pol. Econ. 1325.

<sup>29</sup> J.L. Knetsch, "The Endowment Effect and Evidence of Non-Reversible Indifference Curves" (1989) 79 Am. Econ. Rev. 1277.

resources are put to their most valued use.<sup>30</sup> “Since a receipt foregone of a given amount is the equivalent of a payment of the same amount,”<sup>31</sup> final allocations of entitlements are assumed to be independent of initial entitlements. “[T]he ultimate result (which maximizes the value of production) is independent of the legal position if the pricing system is assumed to work without cost.”<sup>32</sup>

The Coase Theorem test was conducted by randomly giving one member of each of a large number of paired participants a good, a large chocolate bar. Those participants were told it was theirs to take home or to sell, if the person with whom they were paired made a sufficiently attractive offer. The experiment was deliberately arranged so that the potential buyers had been given a larger windfall sum of money than the sellers. Despite this effort to encourage buyers to use their unanticipated gain to make larger offers to acquire the goods, few transactions were concluded.<sup>33</sup> In spite of the entitlements’ random distribution, the people holding them demanded much more to give them up than potential buyers were willing to pay to acquire them. The valuations were *not*, contrary to the Coase prediction, independent of the initial assignments of entitlements.<sup>34</sup>

Individuals have now repeatedly been shown to exhibit disparities between gain and loss valuations in experimental settings, as reported by many investigators using a variety of methods to evaluate widely varied assets. As well, people’s actual behaviour in making everyday choices increasingly has been observed to be consistent with these findings. For example, the valuation disparity and consequent reluctance to sell at a loss is observed in the greater volume of house sales when prices are rising, over the number when they are falling. This can also be observed in the smaller volume of sales of securities that have declined in price relative to those for which prices have increased.<sup>35</sup>

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<sup>30</sup> R.H. Coase, “The Problem of Social Cost” (1960) 3 J. L. & Econ. 1.

<sup>31</sup> *Ibid.* at 7.

<sup>32</sup> *Ibid.* at 8.

<sup>33</sup> *Supra* note 28.

<sup>34</sup> The major efficiency implications of the valuations of gains and losses have been demonstrated in H. Hovenkamp, “Legal Policy and the Endowment Effect” (1991) 20 J. Legal Stud. 225 at 230.

<sup>35</sup> H. Shefrin & M. Statman, “The Disposition to Sell Winners Too Early and Ride Losers Too Long: Theory and Evidence” (1985) 40 J. Fin. 777.

Firms frequently are reluctant to divest themselves of plants and product lines even though they would not consider buying these same assets, and stock prices often rise when they do give them up.

A further illustration of the differing valuations of gains and losses is provided by responses to recent automobile insurance legislation in two American states. In both jurisdictions people are given a choice between cheaper policies, which limit rights to subsequent recovery of further damages, and a more expensive policy permitting such actions. Importantly, the default option differs: the *reduced* rights policy is offered in New Jersey unless it is given up; and *full* rights policy is given in Pennsylvania unless the less expensive option is specified. Given the minimal costs in both states of choosing either option and the large amounts of money at issue, the results have been dramatic. At last count over 70 per cent of New Jersey automobile owners have adopted the reduced rights policy, but fewer than 25 per cent of Pennsylvanians have done so.<sup>36</sup>

The differing weights attached to gains and losses have also been found to influence the judgment of what people regard as acceptable or unfair behaviour in economic relationships. If an action is seen to impose a loss on one party for the benefit of another, this will nearly always be widely seen to be unfair—quite apart from whatever economic justification might exist. For example, raising prices in response to sudden shifts in demand is seen to benefit the seller, who has not incurred any cost increase, at the expense of the buyer and is, therefore, judged to be unfair. Similarly, cutting wages when unemployment increases is thought to be unfair by the vast majority of people because the employer benefits in direct proportion to the worker's loss. As a less aversive relinquishment of a gain, the reduction of a customary bonus payment to workers is apparently viewed as more acceptable than an equivalent reduction in wages, which is commonly seen as imposing a loss on workers.<sup>37</sup>

Raising rents of a new, as opposed to a sitting, tenant or cutting wages of a new, rather than an old, employee is generally considered to be fair because the benefit to the landlord or the employer is not seen to

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<sup>36</sup> J. Meszarose *et al.*, *Framing, Loss Aversion and Insurance Decisions* (Working Paper) (Philadelphia: University of Pennsylvania Press, 1991).

<sup>37</sup> D. Kahneman, J.L. Knetsch & R.H. Thaler, "Fairness as a Constraint on Profit Seeking: Entitlements in the Market" (1986) 76 *Am. Econ. Rev.* 728.

be gained at the expense of a loss to the other party. The evidence also suggests a willingness of most people to back up their judgments with sacrifices to punish unfair behaviour and reward what they take to be fair dealings.<sup>38</sup> A major motivation for these judgments appears to be that losses matter more to people than do foregone gains.

This strong intuition to value losses more than commensurate gains, and the implications for the resolution of competing claims, was summarized earlier by Holmes in the following terms:

It is in the nature of man's mind. A thing which you have enjoyed and used as your own for a long time, whether property or an opinion, takes root in your being and cannot be torn away without your resenting the act and trying to defend yourself, however you came by it. The law can ask no better justification than the deepest instincts of man.<sup>39</sup>

While there has been very little empirical work investigating this phenomenon among legal actors, Stewart Macaulay's seminal work in the sociology of law almost three decades ago offers some support for the appearance of this phenomenon among members of at least one business community when they confront legal disputes.<sup>40</sup> Macaulay interviewed sixty-eight business people and lawyers representing forty-eight companies and six law firms. All but two of the companies were engaged in manufacturing, with plants in Wisconsin. In his investigation of dispute settlements, Macaulay began with the formal assumption that, on breach of contract, the breaching party, the buyer, for example, would be legally obligated to pay all of the seller's wasted expenses up to the time of breach, plus anticipated lost profits. However, the responses of the purchasing agents and sales personnel revealed attitudes consistent with the experimental data discussed above. That is, they uniformly believed that all they ought to recover or to pay in damages was an amount representing the seller's actual expenses:

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<sup>38</sup> D. Kahneman, J.L. Knetsch & R.H. Thaler, "Fairness and the Assumptions of Economics" (1986) 59 J. Bus. 285.

<sup>39</sup> O.W. Holmes, "The Path of Law" (1897) 10 Harv. L. Rev. 457 at 477. The only difference revealed by the empirical evidence is that the reluctance to give up something does not necessarily only occur after "a long time," but may well set in immediately. Once a reference position is perceived, which leads to a change being viewed as a loss, then the valuation will respond accordingly. See, particularly, *supra* note 28.

<sup>40</sup> See "Non-Contractual Relations in Business: A Preliminary Study" (1963) 28 Am. Soc. Rev. 55.

[A]ll ten of the purchasing agents [that were] asked about cancellation of orders once placed indicated that they expected to be able to cancel orders freely subject to only an obligation to pay for the seller's major expenses such as scrapped steel. All seventeen sales personnel asked reported that they often had to accept cancellation. One said "You can't ask a man to eat paper [the firm's product] when he has no use for it."<sup>41</sup>

The empirical findings discussed earlier, together with Macaulay's evidence, suggest that people value gains and losses from some neutral reference point or level. Losses from this reference are commonly weighed more than gains beyond it. The reference position, therefore, determines whether an adverse change is regarded as a loss or as a foregone gain, and whether a positive change is treated as a gain or as a reduction of a loss. Given the large disparities between valuations, these differences can have significant practical impact.

### III. THE DISPARITY AND JUDICIAL CHOICE

The legitimacy of the common law has largely been based on its decentralized, *ad hoc*, incremental development by judges who have little enforcement power, and who therefore respond to an intuitive, non-empirical interpretation of community mores and individual preferences. If such interpretations underlie individual judgments, then a phenomenon as pervasive as the valuation disparity would be expected to be implicated, either explicitly or implicitly, in the development of legal doctrine. Indeed, as expected, the idea that *losses count more than expected gains* is encountered in an enormous range of ideas in law.<sup>42</sup>

An important way in which the valuation disparity has been incorporated in law is through the widespread recognition of possession as a foundation for the declaration or recognition of legal entitlements.<sup>43</sup>

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<sup>41</sup> *Ibid.* at 64.

<sup>42</sup> Other, independent, *ad hoc* explanations can be offered for many specific results, but the valuation disparity alone appears uniquely robust as a consistent explanation across a wide range of apparently independent legal issues.

<sup>43</sup> One of the most articulate writers on the relationship of possession and the human condition is C.B. MacPherson who, in *The Political Theory of Possessive Individualism* (Oxford: Clarendon Press, 1962) at 3, wrote that "[t]he human essence is freedom from dependence on the wills of others, and freedom is a function of possession." See also British Columbia Law Reform Commission, *Wrongful Interference with Goods* (Working Paper No. 67) (Vancouver: British Columbia Law Reform Commission, 1992) at 21.

The often misused expression that “possession is nine-tenths of the law”<sup>44</sup> is a manifestation of judicial intuition that possession of things is intimately connected to establishing the endowment effect, and underlies judicial choices favouring protection against losses over foregone gains.

Both legal writers and the designers of the empirical studies discussed earlier have used the term possession in extremely ambiguous ways. But regardless of one’s choice of definition, it is incontrovertible that judicial sensitivity to the notion of possession, or seisin, in English law is deeply rooted and utterly pervasive: “In the history of our law there is no idea more cardinal than that of seisin.”<sup>45</sup>

Frederick Pollock,<sup>46</sup> while noting that it was difficult to obtain a consistent doctrine or consistent terminology,<sup>47</sup> offered several theories on why judge-made common law presumes in favour of possession.<sup>48</sup> Utilitarian justifications for the protection of possession range from a concern with reducing the risk of civil disobedience—a response to the risk of personal injuries associated with self-help dispossession—to the

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<sup>44</sup> Historians have traced its development from Roman rather than Germanic Law. See S.S. Peloubet, *A Collection of Legal Maxims in Law and Equity, with English Translations* (Littleton, Colo.: F.B. Rothman, 1985) at 225; Sir F. Pollock & F.W. Maitland, *The History of English Law: Before the Time of Edward I*, vol. 2, 2d ed. (Cambridge: Cambridge University Press, 1968) at 29. In *The Corporation of Kingston-upon-Hull v. Horner*, [1774] Lofft. 592, 98 E.R. 807 at 815 (K.B.), Lord Mansfield C.J. said, “Possession is very strong; rather more than nine points of the law.” He used the expression in a case concerning prescriptive rights where, in the absence of evidence of a crown grant, one was presumed to exist, thus supporting a possessory title. By 1881 in *Beddal v. Maitland* (1881), 17 Ch.D. 174 at 183 (H.C.), Sir Edward Fry was noting that the old saying that possession is nine points of the law was created by a forcible entry statute, which resulted in a man in possession being able to use force to keep out a trespasser. If a trespasser had gained possession, however, the rightful owner could not use force to put him out, but had to appeal to the law for assistance. As late as 1946, *Wharton’s Law Lexicon* was expressing the idea as possession constituting “nine points” of the law: A.S. Oppé, ed., *Wharton’s Law Lexicon*, 13th ed. (London: Stevens, 1938) at 666. H.C. Black, ed., *Black’s Law Dictionary*, 6th ed. (St. Paul, Minn.: West Publishing, 1990) at 1164, currently uses the phrase: “Possession is nine-tenths of the law.”

<sup>45</sup> Pollock & Maitland, *ibid.* at 29. See also F. Pollock & R.S. Wright, *An Essay on Possession in the Common Law* (Oxford: Clarendon Press, 1888) at 1.

<sup>46</sup> Both with R.S. Wright (see Pollock & Wright, *ibid.*) and with F.W. Maitland (see Pollock & Maitland, *ibid.*).

<sup>47</sup> Pollock & Maitland, *ibid.* at 44. Pollock and Maitland make the point that “so far as concerns our own English law we make no doubt that at different times and in different measures every conceivable reason for protecting possession has been felt as a weighty argument and has had its influence on rights and remedies.” *Ibid.*

<sup>48</sup> *Ibid.* at 40.

protection of ownership interests. But once again, we find references to the *natural* expectation that a person should and will be allowed to keep what he or she possesses until someone has proved a better title.<sup>49</sup>

#### A. *Adverse possession*

The rule of adverse possession provides a means by which the user of property can successfully assert a claim of ownership over a prior owner. Many of the cases involve mistakes on the location of boundaries.<sup>50</sup> Others, however, reward those who make effective use of an asset over an owner who has effectively abandoned it.<sup>51</sup>

The advantages in efficiency of awarding titles to adverse possessors usually include the reduction of administrative costs of establishing rightful ownership and the encouragement to make productive use of assets that are left unused by their owners.<sup>52</sup> Posner suggests a further advantage in efficiency of the rule of adverse possession turning on possible differences between the valuations of owners and possessors because of differences in the marginal value of their wealth levels:

The adverse possessor would experience the deprivation of property as a diminution in his wealth; the original owner would experience the restoration of the property as an increase in *his* wealth. If they have the same wealth, then probably their combined utility will be greater if the adverse possessor is allowed to keep the property.<sup>53</sup>

Posner chooses to interpret Holmes's views<sup>54</sup> of the disparity between feelings of gains and losses as "a point about diminishing marginal utility

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<sup>49</sup> *Ibid.* at 41-43.

<sup>50</sup> Distinctions in granting variances are commonly made between not requiring destruction of an improvement built too close to a neighbour by mistake and proposing to do so, and between wilfully ignoring a zoning ordinance and doing so by mistake.

<sup>51</sup> While now largely matters of statute in most jurisdictions, the rules grew out of resolutions favouring current users because of the difficulty of establishing old entitlements due to lost records and fading memories. See R. Cooter & T. Ulen, *Law and Economics* (Glenview, Ill.: Scott, Foresman & Company, 1988).

<sup>52</sup> See *ibid.*; W.Z. Hirsch, *Law and Economics: An Introductory Analysis* (New York: Academic Press, 1979).

<sup>53</sup> R. Posner, *An Economic Analysis of Law*, 3d ed. (Boston: Little Brown, 1986) at 70.

<sup>54</sup> See Holmes, *supra* note 39.



of income.”<sup>55</sup> The evidence discussed earlier suggests instead that Holmes’s notion is a prescient articulation of the endowment effect, that is, the disparity between the valuation of gains and losses. The reference positions are probably such that taking away from a current user would likely be valued as a loss, and giving back to the original owner would likely be valued as a gain. And given the greater valuations of losses over gains, the rule seems consistent with maximizing joint welfare, quite apart from any concern with the diminishing marginal utility of income or any incentives to encourage investment and use.

The potential gains depend on how well the limitations and restrictions on length of time and behaviour needed to acquire title reflect reference positions of the parties and their consequent views of gains and losses. If a person makes very temporary use of a parcel of land while the owner is absent for a short time, the reference position is unlikely to shift, and an award of title would then be taken as a gain. If the use continues over many years, a reasonable expectation of continued use would probably develop so that any unexpected termination would be viewed as a more important loss. An owner deprived of title after a short absence would surely take this as a loss, and the discovery that ownership extended several metres beyond an old boundary fence would likely be regarded as a less valued gain.

The rules of adverse possession may be consistent with lowering administrative costs and encouraging use. Neither addresses, however, the disparate valuations—and consequent efficiency outcomes—that depend on perceptions of gains and losses, and the specification of requirements in terms of reference positions. A short limitation period might well induce use of *unused* property. If such a specification leaves the original owner in the domain of losses and the possessor feeling that the title is a gain, the result is likely to be an inefficient change in which the gain is outweighed by the loss.

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<sup>55</sup> *Supra* note 53. This was previously observed by R.C. Ellickson, “Bringing Culture and Human Frailty to Rational Actors: A Critique of Classical Law and Economics” (1989) 65 *Chicago-Kent L. Rev.* 23 at 38.

### B. Limitations on Recovery of Lost Profits

A second, more specific example of the operation of the valuation disparity on judicial decisions is the reluctance of judges to compensate for *lost profits*, whether the claim is framed in contract or tort. As Adam Smith wrote: “[W]e naturally depend more on what we possess than what is in the hands of others. A man robbed of five pounds thinks himself much more injured than if he had lost five pounds by a contract.”<sup>56</sup> When permitting the recovery of economic losses in tort law, this idea is reflected in the consistent distinction that judges draw between loss by way of expenditure and failure to make gain.<sup>57</sup> While recovery of expenditures is sometimes permitted, recovery of foregone gains is not.<sup>58</sup> Several recent decisions have explicitly recognized the distinction. In one, *Dominion Tape of Canada Ltd. v. L.R. McDonald & Sons Ltd.*,<sup>59</sup> several bales fell from a trailer and hit a hydro pole, cutting power to the plaintiff’s plant. The plaintiff successfully sued to recover wages paid to employees, which represented *positive outlays*; but could not recover loss of profits, which were only *negative losses*, consisting of a “mere deprivation of an opportunity to

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<sup>56</sup> *Lectures on Justice, Police, Revenue and Arms*, ed. by E. Cannan (Oxford: Clarendon Press, 1896) at 131.

<sup>57</sup> Thus in R.W.M. Dias, ed., *Clerk & Lindsell on Torts*, 15th ed. (Agincourt, Ont.: Carswell, 1982) at 32-33 and at 371-385, the authors typically offer the formal statement that recovery has been extended to economic losses representing expenditures, but “the general rule is that loss of profit *per se* is not actionable: there is a no duty-situation.” Similarly, in *Weller & Co. v. Foot and Mouth Disease Research Institute* (1965), [1966] 1 Q.B. 569, [1965] 3 All E.R. 560, the Court held that the loss of profit did not constitute a harm of a sort that the law would remedy, and that the rule against recovery is independent both of negligence and foreseeability.

<sup>58</sup> The House of Lords’ decision in *Junior Books Ltd. v. Veitchi* (1982), [1983] 1 A.C. 520, [1982] 3 W.L.R. 477 [hereinafter *Junior Books*], which might have presented a radical development in compensation law and which permitted recovery of lost profits in a non-contractual setting, has not been widely followed. See J.F. Clerk, *Fifth Cumulative Supplement to the Fifteenth Edition*, ed. by R.W.M. Dias (London: Sweet & Maxwell, 1987) at paras. 10-14, which describes six limiting factors on the *Junior Books* decision.

<sup>59</sup> [1971] 3 O.R. 627, 21 D.L.R. (3d) 299 (Co. Ct.). See also *MacMillan Bloedel Ltd. v. Foundation Co. of Canada Ltd.* (1977), 75 D.L.R. (3d) 294, [1977] 2 W.W.R. 717 (B.C.S.C.) (employer may be permitted to recover actual wages paid to employees); and *Ontario (A.G.) v. Crompton* (1976), 14 O.R. (2d) 659, 74 D.L.R. (3d) 345 (H.C.J.) (specific expenditure incurred in putting out fire recoverable).

earn an income." The latter, while foreseeable, was judged as too remote.<sup>60</sup>

While lost profits are said to be recoverable in contract law, it is difficult to defend the proposition that the *expectation* interest of a non-breaching party is recognized in contract actions in the same fashion as are *actual* losses.<sup>61</sup> As Atiyah argued, the costs of depriving a breaching party of his or her wealth are considered by most to outweigh the expected benefit to the non breaching party: "[I]t might well be thought by most people that the inconvenience to the promisor of being held to his contract would be enough to outweigh the *prima facie* desirability of not disappointing the promisee."<sup>62</sup> Fuller and Perdue in their seminal article, "The Reliance Interest in Contract Damages,"<sup>63</sup> argued that the public interest in redressing wrongs varies directly with the type of claim that the complainant makes. In their eyes, it is relatively easy to justify claims to compensation where the plaintiff is seeking return of wealth transferred to the defendant, and almost as easy to justify claims to compensation for actual out-of-pocket expenses incurred as a result of the breach of contract. However, while contract law protects expectations of gain: "[I]n passing from compensation for change of position to compensation for loss of expectancy ... [t]he law no longer seeks ... to heal a disturbed *status quo*, but ... assumes a more active role. *With the transition, the justification for legal relief loses its self-evident*

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<sup>60</sup> This approach received some support from Wilson J.A. as an innovative approach in *Ontario (A.G.) v. Fatehi* (1981), 34 O.R. (2d) 129 at 140, 127 D.L.R. (3d) 603 at 615 (C.A.), rev'd [1984] 2 S.C.R. 536, 15 D.L.R. (4th) 132.

<sup>61</sup> Thus Hugh Collins writes that "[i]n practice ... the courts rarely countenance the ... head of damages for anticipated profits." H. Collins, *The Law of Contract* (London: Weidenfeld & Nicolson, 1986) at 181-82. See also L.E. Wolcher, "The Accommodation of Regret in Contract Remedies" (1988) 73 Iowa L. Rev. 797 at 873.

The most vocal proponent of the thesis that contract liability is based on reliance and restoration of benefits, and thus that contract recovery should be similarly defined, is Patrick Atiyah, who has made this point on several occasions. See P.S. Atiyah, *The Rise and Fall of Freedom of Contract* (Oxford: Clarendon Press, 1979) at 763-779. See also P.S. Atiyah, "Contracts, Promises and the Law of Obligations" (1978) 94 L.Q. Rev. 193.

<sup>62</sup> "Contracts, Promises and the Law of Obligations," *ibid.* at 216. Professor Scott has more pointedly written of the intuition that "a loss of \$100.00 is more unpleasant than a gain of \$100.00 is attractive." R.E. Scott, "Error and Rationality in Individual Decisionmaking: An Essay on the Relationship Between Cognitive Illusions and the Management of Choices" (1986) 59 S. Cal. L. Rev. 329 at 335.

<sup>63</sup> (1936) 46 Yale L.J. 52 at 53-57.

quality.”<sup>64</sup> Fuller and Perdue justify the protection of economic expectations by explaining that the promisee’s assets are *actually* reduced but only in the sense that this would be understood “according to the modes of thought which enter into our economic system.”<sup>65</sup> Moreover, they explain that the reason for the protection of expectations is that the adoption of a rule, which protects foregone opportunities is, in effect, the most effective means of encouraging reliance and thus compensating for actual incurred losses!

In recent years, several judges have reinterpreted the application of *remoteness* limitations on contract damage recovery. Remoteness concepts are employed to place limits on damage awards by requiring that the risk of loss be foreseeable with some degree of probability at the time of contracting.<sup>66</sup> The doctrinal rules support the view that the limiting concepts are not the same in tort as in contract, and that tort law—employed to compensate for actual losses rather than forgone gains—“imposes a much wider liability.”<sup>67</sup>

The valuation disparity has been explicitly recognized in *H. Parsons (Livestock) Ltd. v. Uttley Ingham & Co.*,<sup>68</sup> where the Court considered the recoverability of losses associated with the sale and installation of a defective feed hopper. Lord Denning reinterpreted earlier remoteness cases as establishing two distinct rules, which could be understood as applying *not* to the doctrinal categories of tort and contract, but rather to the kinds of losses for which compensation was being sought. In the case of physical damage and actual expenses, the injured party should be able to recover losses which are foreseeable as resulting from a breach of contract even if, at the time of contract, there

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<sup>64</sup> *Ibid.* at 56-57 [emphasis added].

<sup>65</sup> *Ibid.*

<sup>66</sup> The common law rules defining remoteness concepts in contract and tort are expressed in *Koufos v. C. Czarnikow Ltd.* (1967), [1969] 1 A.C. 350, [1967] 3 W.L.R. 1491, [1967] 3 All E.R. 686 (H.L.), and *Overseas Tankship (U.K.) Ltd. v. The Miller Steamship Company* (1966), [1967] 1 A.C. 617, 3 W.L.R. 498 [1966] 2 All E.R. 709 (P.C.) [hereinafter *The Wagon Mound No. 2*], respectively. In the former case, all of the judges attempted to delineate the particular degree of probability with which the parties ought to have foreseen the risk of loss resulting from the breach of contract. *The Wagon Mound No. 2* served similar purposes in the law of torts—the issue being whether the defendant ought to be liable for all reasonably foreseeable risks regardless of their degree of probability or whether some threshold statistical level of probability would trigger liability.

<sup>67</sup> Lord Reid in *The Wagon Mound No. 2, ibid.* at 634.

<sup>68</sup> (1977), [1978] Q.B. 791, [1977] 3 W.L.R. 990, [1978] 1 All E.R. 525 (C.A.).

was only an extremely small probability of the loss occurring. However, claims representing loss of profit or loss of opportunities for gain are recoverable only if the risk of loss was contemplated as a serious possibility or a real danger.<sup>69</sup> The obvious result, whether or not one supports Lord Denning's re-articulation of the traditional remoteness rules,<sup>70</sup> is that the likelihood of recovery of losses is far greater than the likelihood of recovery of unrealized gains.

The principle reflected in this decision—that physical injuries and property damage should be given greater legal protection than unrealized expected economic gains—is again consistent with the empirical observation that people value losses more than foregone gains.

### C. *Contract Modifications*

A third area where the valuation disparity manifests itself is in the distinctive treatment of performed and unperformed *intra-contractual promises*. For example, where a person promises to pay an additional amount of money for a previously arranged contractual performance,<sup>71</sup> the courts have uniformly denied the promisee the right to enforce the promise.<sup>72</sup> Thus, if a construction company agrees to pay

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<sup>69</sup> This idea was articulated by H.L.A. Hart & A.M. Honore in *Causation in the Law* (Oxford: Clarendon Press, 1959) at 281-87. It is also explicitly recognized in some Civilian jurisdictions. For example, the German Civil Code limits contract recovery in certain cases to the "negative" or reliance interest, as discussed in G.E. Clos, *Comparative Law* (Littleton, Colo.: Fred B. Rothman & Co., 1979) at 226-236. Furthermore, article 252 explicitly limits recovery of losses of particular gains to situations where the risk is foreseeable as a probable consequence of the breach. See Germany, *The German Civil Code*, trans. by I.S. Forrester, S.L. Goren & H.-M. Ilgen (South Hackensack, N.J.: Fred B. Rothman & Co., 1975).

<sup>70</sup> The judgment is important because he confesses that the physical injury/property damage versus economic loss distinction operates *de facto* whatever formal test one accepts. See *supra* note 68 at 533 where he emphasizes a particular set of product liability cases in which personal injury claims were compensated "even though [manufacturers and retailers] had not the faintest suspicion of any trouble."

<sup>71</sup> The same anomaly operates where a creditor promises to accept less than the full amount owing from a debtor. At common law, the creditor could retract the promise even where the debtor had paid the money. See *Foakes v. Beer* (1884), 9 App. Cas. 605 (H.L.). However, the *Mercantile Law Amendment Act*, R.S.O. 1980, c. 265, s. 16, provides that *part performance* of the promise will extinguish the obligation. Again, the distinction is simply where the money is *located*.

<sup>72</sup> See *Gilbert Steel Ltd. v. University Construction Ltd.* (1976), 12 O.R. (2d) 19, 67 D.L.R. (3d) 606 (C.A.).

an additional \$20,000 to ensure delivery of steel, which has already been contracted for, the court will not enforce the promise to pay the additional sum. However, if the construction company agrees to pay the additional \$20,000 and actually transfers the money to the steel supplier, the promise is presumptively enforceable. The court will not order the money to be returned unless the construction company can demonstrate that the money was extorted from it under conditions of economic duress.<sup>73</sup>

The situations are indistinguishable except, again, for the location of the money. In the first example, the court will not order the transfer of wealth from the promisor to the promisee, preferring the *status quo*. In the second example, the court will not order the return of the wealth from the promisee to the promisor, again preferring the *status quo*. There are very persuasive reasons for singling out these *intra-contractual* promises for special treatment. They represent very real risks of extortion generated by reliance-based situational monopolies; they introduce uncertainty relating to the authority to make the alleged modification of the agreement; and they generate additional transaction costs to contractual dispute resolution. But those reasons apply with equal force to performed and unperformed promises. The distinction developed in the cases is, once more, consistent with the empirical data, which point to significant welfare losses in the case of coerced transfers of wealth.

#### D. *Gratuitous Promises*

Judges have traditionally and consistently drawn a distinction between *giving* a gift to someone and *promising* to do so.<sup>74</sup> Performed

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<sup>73</sup> See R. Goff & G. Jones, *The Law of Restitution*, 2d ed. (London: Sweet & Maxwell, 1978). See *Peter Kiewit Sons' Co. of Canada v. Eakins Construction Ltd.*, [1960] S.C.R. 361, 22 D.L.R. (2d) 465; *Re Municipal Spraying & Contracting Ltd.* (1980) 15 B.L.R. 37, (*sub nom. Municipal Spraying and Contracting Ltd. v. Nfld.*) 153 A.P.R. 91 (Nfld. T.D.) (plaintiff entitled to recover \$195,000 worth of additional work performed for defendant on ground that performance was rendered in response to threatened legal action and was not voluntary).

<sup>74</sup> See M.A. Eisenberg, "The Principles of Consideration" (1982) 67 Cornell L. Rev. 640; M.A. Eisenberg, "Donative Promises" (1979) 47 U. Chi. L. Rev. 1; and *Halsbury's Laws of England*, 4th ed., vol. 20 (London: Butterworths, 1978) para. 62 at 36: "where a gift rests merely in promise, whether written or verbal ... it is incomplete ... and the court will not compel the intending ... to complete and perfect it."

gifts are enforceable; unperformed promises to give gifts are not. The undelivered gift cases are consistent with contract doctrines; the courts have not looked kindly on gratuitous promises<sup>75</sup> either at common law or at equity, and normally the rule is that they are not enforceable.<sup>76</sup> The major exception to the bargain theory of consideration is the enforcement of promises that have generated reasonable, detrimental reliance.<sup>77</sup>

Eisenberg classifies donative promises into three groups: informal and not relied-upon, formal but not relied-upon, and relied-upon.<sup>78</sup> Judges have consistently refused to enforce those gift promises that fall into the first and second categories. Several underlying rationales for the non-enforcement have been examined by several authors and various explanations have been offered. For example, Posner argues that the rule perhaps reflects an empirical *hunch* that "gratuitous promises tend to ... [involve] small stakes"<sup>79</sup> and, therefore, that the social costs of enforcing the promise will generally exceed the utility of doing so. Swan and Reiter suggest that we are naturally suspicious of gift promises. Because the law has provided rules for the completion of legally enforceable gifts, we should ask ourselves why those rules were not followed and whether, in fact, the donor really intended to complete the gift.<sup>80</sup>

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<sup>75</sup> Gratuitous or donative promises are those given without the exchange of something of value, whether it be tangible property or another promise. *Currie v. Mesa* (1875), L.R. 10 Ex. 153, 23 W.R. 450; *Spruce Grove v. Yellowhead Regional Library Board* (1982), 44 A.R. 48, 143 D.L.R. (3d) 188, 21 M.P.L.R. 62 (C.A.).

<sup>76</sup> See for example, A.G. Guest, *Anson's Law of Contract*, 26th ed. (Oxford: Clarendon Press, 1984) at 82.

<sup>77</sup> R.A. Posner, "Gratuitous Promises in Economics and Law" (1977) 6 J. Leg. Stud. 411; and C. Fried, *Contract as Promise* (Cambridge: Harvard University Press, 1981) at 56.

<sup>78</sup> "Donative Promises," *supra* note 74 at 6-11.

<sup>79</sup> Posner, *supra* note 77 at 417. Posner argues that "[p]romises should not be enforced where the enforcement cost—to the extent not borne by the promisor—exceeds the gains from enforcement," and where the only reason for enforcement would be an increase in net social welfare. *Ibid.* at 414. It would, as Posner puts it at 417, be uneconomical to enforce casual social promises where the increment in utility to the promisor would be small if the promise were enforceable and the legal error costs high.

<sup>80</sup> J. Swan & B.J. Reiter, *Contracts, Cases, Notes and Materials*, 3d ed. (Toronto: Emond Montgomery, 1985) at 223; and M.D. Bayles, "Legally Enforceable Commitments" (1985) 4 L. & Phil. 312 at 338.

An alternative explanation points to the small welfare loss associated with not receiving a gift, which is measured by the donee's foregone gain of the opportunity, relative to the welfare loss associated with depriving an existing owner of property of an entitlement, which is measured by the owner's asking price to give it up. This explanation, unlike the others, is consistent with the empirical data described earlier. Thus, Eisenberg argues that "lost expectation—a special form of disappointment—is among the least intense of injuries" and, therefore, is not worthy of legal remedy.<sup>81</sup> Since "lost expectation" is a foregone gain, Eisenberg clearly reveals an intuitive awareness of the valuation disparity and its role in understanding and predicting judicial choice. An unperformed gift promise is not treated as a loss. The "wrench of delivery"<sup>82</sup> has not been experienced by the promisor and no *real* loss has been experienced by the promisee.

A more realistic assessment of gains and losses, taking the valuation disparity into account, would predict that gratuitous promises that are relied upon will often be enforced because in those cases a *real* loss would have been incurred.<sup>83</sup> In *Skidmore v. Bradford*,<sup>84</sup> a nephew was promised a gift of a warehouse by his uncle who, in addition to paying one thousand pounds towards the purchase price of five thousand pounds, had asked the owner to amend the agreement by writing in the nephew's name and by preparing the receipt in the nephew's name. Before he died, the uncle paid a further five hundred pounds on the purchase price. Since the nephew had signed the agreement to purchase, he was held liable for it. He paid, sued the uncle's estate to enforce the promise to give the warehouse as a gift, and *won*. There the Court held that the nephew had "incurred that liability on the faith of the representations of the testator that he would give him the warehouse."<sup>85</sup>

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<sup>81</sup> "Donative Promises," *supra* note 74 at 3. See also "The Principles of Consideration," *supra* note 74 at 656 where he says that "[t]his principle can be justified on several grounds, the most important of which is the low level of injury resulting from breach."

<sup>82</sup> P. Mecham, "The Requirement of Delivery in Gifts of Chattels and of Choses in Action Evidenced by Commercial Instruments" (1926) 21 Ill. L. Rev. 341 at 348-49.

<sup>83</sup> This is, in effect, the argument presented by P. Atiyah, *Consideration in Contracts: A Fundamental Restatement* (Canberra: Australian National University Press, 1971).

<sup>84</sup> (1869), L.R. 8 Eq. 134.

<sup>85</sup> *Ibid.* at 137.



Article 90(1) of the *Restatement (Second) of Contracts*<sup>86</sup> represents the modern version of this position. It provides that promises, which can reasonably be expected to induce reliance, are binding and should be enforced through remedies "limited as justice requires." While the cases discussing the appropriate remedy under Article 90 are not uniform, a substantial percentage of them award remedies limited by the promisee's reliance losses rather than expected benefits.<sup>87</sup>

### E. Opportunistic Conduct

Opportunistic conduct during contract formation and performance may take several forms, including withholding information during contract formation, taking advantage of ambiguities in language, demanding performance in unintended situations, and failing to perform in order to take advantage of unexpected opportunities. Yet contract negotiations and performance will likely take place more effectively if trust is present and is generated by the process.<sup>88</sup> Risks of opportunism can be reduced by questioning the other's motives, honesty, and future plans,<sup>89</sup> but it is inappropriate and probably dysfunctional to do so.

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<sup>86</sup> *Restatement (Second) of Contracts* § 90 (1981).

<sup>87</sup> See *supra* note 63 at 64-65. See for example, *Goodman v. Dicker*, 169 F.2d 684 (D.C. Cir. 1948); and *Associated Tabulating Services v. Olympic Life Insurance Co.*, 414 F.2d 1306 (5th Cir. 1969).

<sup>88</sup> See R. McKean, "Economics of Trust, Altruism, and Corporate Responsibility" in E.S. Phelps, ed., *Altruism, Morality and Economic Theory* (New York: Russell Sage Foundation, 1975) 29; D. Collard, *Altruism and Economy: A Study in Non-Selfish Economics* (Oxford: Martin Robertson, 1978) at 12; and I.R. Macneil, *The New Social Contract* (New Haven: Yale University Press, 1980).

By trust we mean attitudes and behaviour, which indicate that each person is willing to rely on the other to act fairly and to take into account the other's welfare. Ian Macneil suggests that he uses solidarity and trust as equivalents, referring to a belief in future harmonious affirmative cooperation. See I.R. Macneil, "Exchange Revisited: Individual Utility and Social Solidarity" (1986) 96 *Ethics* 567 at 572.

<sup>89</sup> For an example of opportunistic behaviour in long-term supply contracts, see *Fratelli Gardino S.p.A. v. Caribbean Lumber Co.*, 587 F.2d 204 (5th Cir. 1979). (The seller claims that it is unable to meet contract commitments due to insufficient shipping facilities. The Court finds that facilities were available, but that the seller had chosen to use them for more profitable engagements.)

The treatment by the courts of one form of opportunistic behaviour—deliberate contract breaches motivated by attempts to capture unanticipated profitable opportunities—represents another example of the incorporation of the valuation disparity concept into judicial decision making. Here the valuation disparity manifests itself in *fairness* norms, which track those generated by the *fairness* studies discussed earlier.

One model of contract law, employed by Posner, ignores the motives or gains of a person who breaks a contract. Whether the contract breaker fails to perform in order to avoid losses or to generate windfall gains is irrelevant.<sup>90</sup> An alternate model of contract, which reflects the gain-loss valuation disparity, holds that motives for breach are important, and that failing to perform in order to avoid unanticipated expenses will be treated differently from failing to perform in order to generate a windfall gain to the breaching party.<sup>91</sup> Kessler, Gilmore, and Kronman describe the “implicitly amoral”<sup>92</sup> contract theory of Posner and Holmes, which ignores the motives for breach. Alternatively, they argue that breaches motivated by a gain to the contract breaker will be treated more severely:

Many will say that [the] breach ought still to be condemned from an ethical point of view ... The inclination to blame A will be even stronger if he has benefitted from his breach, although B has not been harmed ... The Holmesian view ... seems never to have fully overcome the resistance of common sense, which stubbornly insists that moral blame (unlike legal liability) is not entirely a function of the consequences of an action but depends, as well, upon the motives and intentions of the actor.<sup>93</sup>

This second model appears to operate more consistently in contract damage disputes.<sup>94</sup> Predictions,<sup>95</sup> both as to liability and the

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<sup>90</sup> See *supra* note 53 and *supra* note 38 at 458-62. See also *Butler v. Fairclough* (1917), 23 C.L.R. 78 at 79; and *Asamera Oil Corp. v. Sea Oil and General Corp.* (1978), [1979] 1 S.C.R. 633, 89 D.L.R. (3d) 1, (*sub nom.* *Baud Corp. N.V. v. Brook no. 2*) [1979] 3 W.W.R. 93.

<sup>91</sup> See A.S. Burrows, *Remedies for Torts and Breach of Contract* (London: Butterworths, 1987) at 252 and at 273.

<sup>92</sup> *Contracts, Cases and Materials*, 3d ed. (Boston: Little, Brown, 1986) at 1067.

<sup>93</sup> *Ibid.*

<sup>94</sup> It may operate in many other contexts as well. For example, deliberate breach for profit may influence judicial discretion in saying that a breach is *fundamental*, thus triggering judicial review of otherwise enforceable exclusion clauses. Or, wilful breach for profit might influence judicial interpretation of terms as conditions rather than warranties. Both choices would work to the contract breaker's disadvantage. Perhaps the application of the mistake doctrines can be

extent of recovery by plaintiffs, vary directly with information on the motives for breach. In addition, the rule that "motives don't count" has been subject to a number of decisions in which judges have explicitly recognized that they are treating the two situations differently and have designed damage awards deliberately to deprive the breaching parties of the gains, which motivated their non-performance.<sup>96</sup>

But the treatment of opportunism is more subtle than merely awarding damages to deprive contract breakers of windfall gains. It extends to the interpretation of facts and the discretionary application of principles, which permit judges to incorporate *fairness* attitudes in their decision making. These fairness norms, like those reflected in the empirical studies described earlier, are associated with the distinction between gains and losses.

The operation of fairness norms in contract law can be demonstrated by contrasting cases in which judges respond differently, depending on whether the otherwise similar behaviour of contracting parties is motivated by attempts to take advantage of unexpected opportunities or by attempts to respond to unanticipated losses.

One example of such a response might be found in the application of promissory estoppel doctrines in contract performance and modification. Promissory estoppel was developed by the courts in

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explained by examining the motives of the person who is seeking to enforce agreements against others who misinterpreted the word or the agreement.

<sup>95</sup> What is surprising is that many, if not all, academics interpret the cases as supporting this view without any data except their intuitions. Thus Kessler, Gilmore and Kronman suggest that, in the case of wilful breach, *the inclination to blame [the contract breaker] will be even stronger if he has benefited from the breach.* *Supra* note 92 at 1067.

<sup>96</sup> For example, in *Penarth Dock Engineering Co. v. Pounds*, [1963] 1 Lloyd's Rep. 359 (Q.B.), a defendant refused to remove its ship from the plaintiff's dock. Even though the plaintiff did not suffer any loss, the Court ordered the defendant to pay money to the plaintiff representing the cost of renting the space, which it saved by not having to rent alternate space.

The cases in which judges have explicitly deprived contract-breakers of the gains generated by breach are characterized, as the valuation disparity data would predict, by behaviour that often represents deliberate interference with possessory or property rights of the plaintiff. Thus, in *Wrotham Park Estate Co. v. Parkside Homes Ltd.*, [1974] 1 W.L.R. 798, [1974] 2 All E.R. 321 (Ch.), the defendants entered into a restrictive covenant with the plaintiff, which prohibited the construction of houses on the plaintiff's property. The defendants built several houses, which did not diminish the value of the plaintiff's property, but were ordered to pay 5% of the 50,000 pounds profit which they made on the construction of the houses. The damages were ordered in lieu of an injunction to demolish the houses. The Court referred to several *tort* decisions, which provided for restitutionary awards in the case of interference with the plaintiff's property; the case had been deemed analogous to that situation. See *supra* note 91 at 274-75.

an effort to protect the interests of contracting parties who rely on the promises for which they did not bargain or representations of their contracting parties. It is applied, as most writers admit, to avoid unjust enrichment and the opportunistic manipulation of legal rules and ambiguous contract language.<sup>97</sup>

A recent example of the application of the doctrine, which offers insight into these underlying *fairness* norms, is a recent decision of the British Columbia Court of Appeal in a dispute between a landlord and a tenant regarding the ability of the tenant to exercise an option to renew its tenancy.<sup>98</sup> The facts were straightforward. Dukes Cookies had entered into a three-year contractual tenancy agreement with the Alma Mater Society of the University of British Columbia. The lease included a term which permitted Dukes to extend the lease for two years if it gave written notice to the landlord during a specific two-month period.

During the term of the lease, Dukes and the Alma Mater Society began negotiations for a new five-year lease. The negotiations included discussions relating to profit-sharing arrangements and an expansion of the leased premises. The negotiations were prolonged until after the two-month notice period had ended. Dukes failed to give written notice to extend the existing lease because they assumed, based on statements made by the Alma Mater Society's principals, that they would obtain a new five-year lease. After the expiry of the two-month notice period, the Alma Mater Society notified Dukes that it would terminate the lease according to its terms because Dukes had not given written notice to extend the original lease. Dukes brought the legal action to prevent the Alma Mater Society from enforcing the written notice provision in the current lease.

Both the trial judge and the Court of Appeal decided the case in favour of Dukes with the result that it was permitted to exercise its option notwithstanding the expiration of the notice period. The formal justification for the decision was the application of the doctrine of promissory estoppel. Through this doctrine, judges can protect the

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<sup>97</sup> See J.A. Manwaring, "Promissory Estoppel in the Supreme Court of Canada" (1987) 10 Dalhousie L.J. 43 at 51. The common law doctrine of promissory estoppel is reflected in *supra* note 86. See also J.M. Feinman, "Promissory Estoppel and Judicial Method" (1984) 97 Harv. L. Rev. 678.

<sup>98</sup> *Re 6781427 Holdings Ltd. and Alma Mater Society of University of British Columbia* (1987), 44 D.L.R. (4th) 257 (B.C.C.A.), *aff'd* (1987), 36 D.L.R. (4th) 753 [hereinafter *Dukes*].

unbargained for reliance of a party to a contract where it would be inequitable to permit the other party to retract a representation that induced the reliance.<sup>99</sup> However, it is obvious from the decision that the Court could just as easily have decided the case in favour of the landlord on either of two grounds. First, the Court could have found that no representation was made by the landlord to the tenant regarding the likelihood of entering into the new arrangement because the testimony of both parties was in conflict on this ground. Also, there was considerable authority that there must be an unequivocal and explicit representation in order to trigger the doctrine. Second, the Court could have found that it was unreasonable for the tenant to infer that the notice provision would not be enforced even if the representation had been made.

What is missing from *both* judgments, and yet what must have been critical from the perspective of everyone concerned, is any evidence explaining the abrupt reversal by the landlord of its negotiation position. Why, one can ask, did the landlord negotiate for months as if it would enter into an extended new lease, and then, without warning, give the tenant notice to vacate the premises?

That is the first question that comes to the mind of many readers, and yet is left unanswered in the reported reasons for the decisions. Discussions with the lawyer for the defendant landlord, however, reveal a very different picture. The lawyer indicates that the trial judge was extremely interested in the motives for the landlord's behaviour—an irrelevant consideration in formal terms.<sup>100</sup> The motive as described in the evidence was simple. The landlord discovered during negotiations that the profits generated by the tenant's business far exceeded its expectations, *and had terminated negotiations in order to open its own cookie business in the same location!* What is remarkable about the case is that neither the trial nor appellate decisions mentions this fact. That is, the motive for the termination of the negotiations

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<sup>99</sup> The American position is not substantially different, although there is considerable debate regarding the extent to which the promisor can be taken to be responsible for the promisee's reliance. See *supra* note 86; and Feinman, *supra* note 97.

<sup>100</sup> That is, the formal doctrine of promissory estoppel, which was applied to justify deciding the case in favour of the tenant, does not include an assessment of the motive of the party who attempts to retract a representation.

consisted of an attempt to obtain unexpected gains at the expense of the tenant.

The case can be interpreted as an example of judges responding to the valuation disparity. That is, the unilateral decision by the landlord to terminate the lease without giving the tenant the opportunity to renew for two years generated an expected gain to the landlord *at the expense of the tenant*. The decision can be seen as a reflection of judicial intuition, consistent with the empirical data on the valuation disparity, that the benefit to the landlord, consisting of expected profit, would be substantially less than the harm imposed on the tenant by the eviction. This valuation disparity gives rise to strong perceptions of unfairness consistent with the empirical evidence indicating that when one person gains at the expense of another—a zero-sum game—the transaction is overwhelmingly seen as unfair.<sup>101</sup>

A second example of judges responding to the valuation disparity and the motive for the defendant's action is a decision on the doctrine of commercial impracticability in *Aluminum Company of America v. Essex Group, Inc.*<sup>102</sup> That case involved a claim for relief from contractual obligations on the doctrinal grounds of mistake, frustration, and commercial impracticability by the plaintiff Alcoa. Alcoa successfully obtained judicially ordered relief from a long-term obligation to process aluminum ore, which had turned out to be unprofitable because of unanticipated increases in Alcoa's energy costs. The case is generally considered remarkable for two reasons. First, the trial judge was forced to distinguish a long line of cases, which most people interpreted as precluding relief where the plaintiff's expected profits had failed to materialize due to unanticipated cost increases. Second, the trial judge did not simply relieve Alcoa from its smelting obligations, but imposed a loss and risk-sharing modification to the contract by developing new pricing terms to reduce the losses to Alcoa associated with the explicit contract pricing arrangement.<sup>103</sup>

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<sup>101</sup> See *supra* note 37.

<sup>102</sup> 499 F. Supp. 53 (W.D. Pa. 1980) [hereinafter *Alcoa*].

<sup>103</sup> The literature on the case is voluminous, although most writers focus on issues other than the distinction between gain and loss, which we consider in this paper. See V.P. Goldberg, "Price Adjustment in Long-Term Contracts" (1985) Wis. L. Rev. 527; R.E. Speidel, "The New Spirit of Contract" (1982) 2 J.L. & Com. 193; and R.E. Speidel, "Court Imposed Price Adjustments under Long-Term Supply Contracts" (1981) 76 Nw. U.L. Rev. 369.

In *Alcoa*, the Court explicitly recognized *fairness* norms as justifying judicial choices.<sup>104</sup> The problem, of course, is identifying or articulating the content of this fairness norm. Again, as in *Dukes*, the interpretation of judicial behaviour is problematic. But the judgment includes a reference to the formally *irrelevant* fact that, when Essex Group had discovered that it was in a position to own substantial amounts of very cheap aluminum, it decided to enter the commodities market. Instead of ordering and using the aluminum in its commercial operations, it had sought out and entered into contracts with third parties to sell its aluminum at current market prices and, thus, reap a windfall gain at the expense of Alcoa.<sup>105</sup>

Again, the implication of the judgment is consistent with judicial sensitivity to the valuation disparity which generates perceptions of unfairness. Essex Group was gaining a windfall profit at the direct expense of Alcoa, a transaction consistently seen as unfair.

One cannot, of course, point to two ambiguous cases and conclude that judges are responding to conflict only in terms of fairness and the valuation disparity. Certainly there is little explicit recognition of their doing so. What is required to verify the connection of *law* to the fairness data, and what is obviously impossible, is to identify two populations of cases in which all *facts* are identical but for the relevant variable—the acquisition of an advantage at the direct expense of another party. If judges are acting in this way, the outcomes in the two groups of cases should be different.<sup>106</sup>

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<sup>104</sup> See *supra* note 102 at 76, where the trial judge alludes to the idea that the contract would not be enforced where it would be “commercially senseless and unjust.” See also “The New Spirit of Contract,” *ibid.* at 201, referring to the courts’ policing transactions “in the interests of fairness”; and S.W. Halpern, “Application of the Doctrine of Commercial Impracticability: Searching for the ‘Wisdom of Solomon’ ” (1987) 135 U. Pa. L. Rev. 1123, referring to an obligation to act in good faith and to agree to contractual adjustments in order to avoid any fortuitous *advantage* at the expense of the other party.

<sup>105</sup> Apparently, Essex Group was taking advantage of its 36.25 cents per pound price for aluminum by selling 25 per cent of its supply in the open market at the then current market price of 73.13 cents per pound. In fact, Essex Group was underbidding Alcoa and, according to Alcoa, taking Alcoa’s customers. See Note, “Court-Imposed Modifications: Supplementing the All-or-Nothing Approach to Discharge Cases” (1983) 44 Ohio St. L.J. 1079 at 1089 n. 107 and n. 108.

<sup>106</sup> The obvious and insurmountable problem with conducting the experiment is that the two populations of cases do not exist. However, we are not alone in suspecting that deliberate breach for profit is influencing the exercise of judicial discretion. For example, Swan and Reiter, in a discussion of the dissent of Irwin J. in *Peevyhouse v. Garland Coal and Mining Co.*, 382 P.2d 109 (Okla. 1963), suggest that he is responding to deliberate decisions to break contracts and thus gain

### F. Repossession

A final example of judges developing principles consistent with the valuation disparity consists of a series of decisions in which judges have restricted creditors' rights to repossess delivered goods on default by buyers prior to full payment of the purchase price. This is evident first, in the presumptive treatment by judges of time-of-payment clauses, where judges have consistently held that "time is not of the essence" in regard to payment for goods.<sup>107</sup> Without an explicit contract term, the result is that sellers cannot terminate the contract and repossess goods simply on default, and that buyers are given the opportunity to remedy the defect and retain possession.

Second, even where time-of-payment clauses have been expressly stated as conditions—thus apparently permitting the seller to elect to be discharged from the contract and to repossess the goods—the courts have developed several techniques to protect the possessory welfare of the buyer. These include liberal doctrines of waiver<sup>108</sup> and restrictions on the self-help repossession tactics of sellers.<sup>109</sup>

Third, a significant number of jurisdictions have enacted seize-or-sue legislation, which precludes sellers from both repossessing goods and suing for the purchase price.<sup>110</sup> Finally, in many jurisdictions, repossession is permitted only with permission of the court where the

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wealth at the expense of another. See *Contracts, Cases, Notes and Materials, supra* note 80 at 10.

<sup>107</sup> M.G. Bridge, *Sale of Goods* (Toronto: Butterworths, 1988) at 409. See also *Mersey Steel and Iron Co. v. Naylor Benzon and Co.* (1884), 9 App. Cas. 434, [1881-85] All E.R. 365; and *Decro-Wall International S.A. v. Practitioners in Marketing Ltd.*, [1971] 1 W.L.R. 361, [1971] 2 All E.R. 216 (C.A.).

<sup>108</sup> See *Pantoutsos v. Raymond Hadley Corp. of New York*, [1917] 2 K.B. 473, [1916-17] All E.R. Rep. 448 (the failure to object to late payment held to constitute waiver of the right to treat timely payment as a condition).

<sup>109</sup> For example, sellers must give buyers notice of their intention to repossess or take control of property. See *Traders Bank of Canada v. G. & J. Brown Manufacturing Co.* (1889), 18 O.R. 430 (Ch.); and *Royal Bank of Canada v. Cal Glass Ltd.* (1980), 22 B.C.L.R. 328 (C.A.). The restrictions are described in detail in D. Paciocco, "Personal Property Security Act Repossession: The Risk and the Remedy" in M.A. Springman & E. Gertner, eds., *Debtor-Creditor Law: Practice and Doctrine* (Toronto: Butterworths, 1985) at 365. Recent statutory developments have removed the notice requirement. See for example, *The Personal Property Security Act*, C.C.S.M. c. P35, s. 57.

<sup>110</sup> See *Uniform Commercial Code* § 5.103; *The Limitation of Civil Rights Act*, R.S.S. 1965, c. 103, s. 18; *Sale of Goods on Condition Act*, R.S.B.C. 1979, c. 373, s. 20; and *Chattel Mortgage Act.*, R.S.B.C. 1979, c. 48, s. 23.



buyer has paid more than two-thirds of the purchase price.<sup>111</sup> This array of judicial and legislative activity can be explained by the data on the valuation disparity, which would predict substantial welfare losses associated with repossession of goods from debtors on default.

Schwartz has attacked seize-or-sue legislation as being “without coherent justification.”<sup>112</sup> He argues, first, that there is no evidence of systematic underselling of repossessed goods through organized cartels; and second, that repossession does *not* impose greater harms on debtors than it creates gains for creditors. Schwartz does discuss the valuation disparity, but unfortunately, he misses its significance in several ways. First, in discussing the effects of repossession, he admits that the losses associated with repossession may reflect the fact that debtors may value the goods more than the market price. However, he then states that the “harms could not occur if debtors were perfectly informed of the consequences of granting security.”<sup>113</sup> That is, if the future welfare loss were known at the time of contracting, then the debtor would either not grant security, or would grant less and pay a higher interest rate. Whether Schwartz is correct or not depends on when the buyer’s reference point changes, and thus when the repossession is perceived as a loss rather than a foregone gain. If, as seems reasonable, the shift does not take place until some time after possession of the good, then the buyer’s ability to contract *ex ante* is compromised.

Second, even assuming debtor ignorance of the costs of repossession, Schwartz argues that the alleged welfare losses associated with repossession either would not occur or would be trivial. He acknowledges that, if debtors value the goods because they own them and thus, if the amount they would demand to give up their goods exceeds the amount they would pay to obtain the goods in a significant way, then the assignment of legal rights could determine outcomes more frequently than is commonly supposed. However, the valuation disparity may be linked to a kind of relationship connected not to the assignment of legal rights, but to possession. If that is so, then merely shifting *ownership* will not eliminate the valuation disparity.

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<sup>111</sup> See for example, *Consumer Protection Act*, R.S.O. 1980, c. 87, s. 23(1).

<sup>112</sup> A. Schwartz, “The Enforceability of Security Interests in Consumer Goods” (1983) 26 J. L. Econ. 117 at 161.

<sup>113</sup> *Ibid.* at 140.

Third, in assessing whether repossession generates losses, he denies the empirical validity of claims that "creditors necessarily derive less value from repossessed goods than debtors lose."<sup>114</sup> While the empirical studies described above do not support the proposition that the creditors *necessarily* derive less value, they certainly do offer support for the proposition that the loss to the debtor will consistently, and in a very significant way, exceed the expected gain to the creditor.

Finally, Schwartz argues that the gain to the buyer who purchases repossessed goods from the creditor may offset the loss to the original buyer, and thus that repossession does not necessarily destroy value. Again, the empirical studies discussed earlier suggest that the loss of economic welfare measured by the original buyer's reservation price will almost certainly exceed the gain of the second buyer.

Our conclusion, drawn from the empirical evidence described above, is that buyers in possession will consistently value the possessed goods significantly above the value placed on them either by repossessing creditors or hypothetical future buyers, and the purchaser will not generally be able to take the higher valuation into account when contracting. Recognizing this valuation disparity offers considerable support for the judicial restrictions on repossession framed in common law rules and presumptive interpretations of contract language, as well as for the legislative restrictions on repossession adopted in many jurisdictions.

#### IV. CONCLUSION

Contrary to the assertions of conventional economic practice and the prescriptions of many critics of legal outcomes, people commonly do not value losses the same as they value gains. The greater weight given to losses over objectively commensurate gains appears pervasive and is a major determinant of which actions or changes meet community standards of being fair or acceptable and which are likely to be considered unfair or less acceptable.

Further, legal institutions appear to reflect the same disparity between valuations. Court decisions over a very broad array of cases

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<sup>114</sup> *Ibid.* at 142-43.

seem to take account of these differences in according greater protection of losses over foregone gains.

This greater weight given to losses in legal outcomes is not only consistent with people's judgments of fairness and normal business practices but, to the extent that these different weights reflect actual valuations of welfare changes, this differential treatment in judicial choices may also promote efficiency. Equivalent treatment of gains and losses called for by reform proposals "to reconcile" the differences<sup>115</sup> seems not only unlikely to be adopted, but may also lead to inefficient outcomes and may be contrary to community fairness and equity standards.

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<sup>115</sup> Waddams, *supra* note 7 at 540.